DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 07-0188
Income Tax
For The Tax Years 2003-2005

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ISSUES

I. Adjusted Gross Income Tax—Inclusion of Corporations in Combined Return.

Authority: IC § 6-3-2-2(l), IC § 6-3-2-2(m), IC § 6-3-2-2(p), *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 102 S.Ct. 3103 (1982).

Taxpayer protests the Department's decision to require filing a combined return.

STATEMENT OF FACTS

The taxpayer is a retailer operating over one thousand department stores in forty-nine states and Puerto Rico. The taxpayer's business consists of providing a variety of merchandise and services to the consuming public through taxpayer's department stores, printed catalogs, and the Internet. Taxpayer's merchandise includes family apparel, jewelry, shoes, and home furnishings. For the subject tax years, taxpayer was a wholly-owned subsidiary of a holding company incorporated in Delaware (Holding Company); taxpayer was Holding Company's only subsidiary. Taxpayer owns and utilizes a wholly-owned subsidiary corporation for merchandise design and development (Manufacturing Corporation). Purchasing Corporation is a wholly-owned subsidiary of Manufacturing Company, and handles the purchasing and sourcing needs of Taxpayer. Taxpayer utilizes a limited partnership comprised of a general and limited partner, also subsidiaries of Taxpayer, for advertising and media services (Media LP). Taxpayer's business operations also involve several other subsidiary corporations (Other Corporations). While each of the Other Corporations filed separate Indiana returns, Manufacturing Corporation, Purchasing Corporation, and Media LP did not. Taxpayer did not include the Manufacturing Corporation, Purchasing Corporation, or Media LP in its Indiana corporate income tax return for the subject years. The Indiana Department of Revenue ("Department") conducted an audit of the taxpayer for the respective tax periods. As a result of the audit, the Department determined that the relationship between the various corporations indicated that income distortion would result if the taxpayer did not file a combined return in Indiana. Based on the audit and determination, the Department assessed income tax for the audited years. The taxpayer protested the Department's determination and assessments, and a hearing was held. This Letter of Findings results.

I. Adjusted Gross Income Tax—Inclusion of Corporations in Combined Return.

DISCUSSION

The taxpayer protests the Department's determination that the taxpayer should have filed a combined return based upon the taxpayer's relationship with the Manufacturing Corporation, the Purchasing Corporation, and Media LP; and those corporations' economic activity within, or connection to, Indiana. The taxpayer asserts that the Manufacturing Corporation, the Purchasing Corporation, and Media LP are separate entities with separate employees conducting business in an arms-length basis with the taxpayer. The taxpayer summarily asserts that the Manufacturing Corporation, Purchasing Corporation, and Media LP do not have nexus with Indiana.

In support of its assertions, the taxpayer avers the following:

Media LP is a limited partnership composed of a general partner and limited partner, both of which are subsidiaries of the taxpayer. Media LP acts as an advertising agency for the taxpayer, and utilizes just under three hundred employees at facilities in the same geographical location in Texas as that of the taxpayer. Because taxpayer classifies Media LP as a separate entity, Media LP qualifies as a publisher, allowing it to purchase machinery and equipment without paying Texas sales tax. Taxpayer contracted an independent consulting firm to perform a transfer pricing study that yielded data allegedly showing arms-length transactions between Media LP and the taxpayer.

The Manufacturing Corporation is a wholly-owned subsidiary of the taxpayer. Manufacturing Corporation designs and manufactures all private-label merchandise sold by the taxpayer, and utilizes approximately 250 employees at facilities in the same geographical location in Texas as that of the taxpayer. Taxpayer asserts that Manufacturing Corporation functions just like any other unrelated supplier, analogizing it to a number of 'famous-brand' clothing manufacturers. Manufacturing Corporation owns all the trademarks of such merchandise. Manufacturing Corporation does not own any of the intellectual or other intangible property related to the taxpayer's brand name or any of its variations; the taxpayer owns those intellectual property rights.

A services agreement between taxpayer and Manufacturing Company specifies that taxpayer will charge an amount equal to taxpayer's internal cost of providing services to Manufacturing Company, plus the actual cost of any third party services and materials, plus a services fee amounting to six percent of the total internal and external charges. Specified services include "legal, real estate, tax, treasurers/finance, internal audit, risk management & loss prevention, administrative services, and information services."

A separate procurement services agreement between taxpayer and Manufacturing Corporation specifies that Manufacturing Corporation will negotiate merchandise purchase contracts on behalf of and in the name of the taxpayer and to oversee the procurement of merchandise for taxpayer in accordance with taxpayer's instructions and specifications. In exchange for these services, Manufacturing Corporation will charge taxpayer "an amount equal to ten percent of the merchandise supplier's invoice cost to taxpayer on each purchase contract placed by [Manufacturing Corporation]."

As with Media LP, Taxpayer contracted an independent consulting firm to perform a transfer pricing study that yielded data allegedly showing arms-length transactions between Manufacturing Corporation and the taxpayer.

Purchasing Corporation is a wholly-owned subsidiary of Manufacturing Corporation. While Manufacturing Corporation handles purchasing and procurement within the United States and its territories, Purchasing Corporation purchases goods originating in foreign countries. Purchasing Corporation internationally sources merchandise for Manufacturing Corporation.

As with both Media LP and Manufacturing Corporation, Taxpayer contracted an independent consulting firm to perform a transfer pricing study that yielded data allegedly showing arms-length transactions between Purchasing Corporation and the taxpayer.

Taxpayer admits in its protest that Media LP and Manufacturing Corporation are subsidiaries owned by and part of a larger group of entities in taxpayer's nationwide retail business. Taxpayer further admits that Purchasing Corporation is a wholly-owned subsidiary of Manufacturing Corporation. However, the taxpayer contends that the activities presented hereto for which there are intercompany charges are all being provided on an arms length basis and should not be the basis for combining Media LP, Manufacturing Corporation, and Purchasing Corporation into a unitary group for Indiana income tax filing purposes for the subject years. The taxpayer argued that each of these entities represent discrete operating units with no property, payroll, or sales in Indiana. Therefore, taxpayer should not have to file a combined income tax return that includes alleged non-Indiana subsidiaries.

Based upon the information provided by the taxpayer, the Department determined that the activities with, contributions to, and relationships between Media LP, Manufacturing Corporation, Purchasing Corporation, and the taxpayer represent varying interests and business endeavors directly associated with the taxpayer's global business structure. Due to the substantial inter-corporation activities between the members of this group of entities, and to fairly reflect the income earned from Indiana sources, the Department required the taxpayer to file on the unitary basis, and made tax liability assessments on that basis. These three entities perform their respective type of business exclusively for the taxpayer. The Department's audit report shows that the charges assessed to the taxpayer by the three entities create large incomes realized by the charging entities. Taxpayer then realizes gains in the form of non-taxable dividends returned by the charging entities.

Indiana law requires first a determination that the entities are operated as a unitary business. IC § 6-3-2-2(l) provides:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or **the department may require**, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;
(2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis added).

After it has been determined that the entities are unitary, the law requires that the income be reported in such a manner as to "fairly reflect" the Indiana income. IC § 6-3-2-2(m) provides:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The Department may also necessarily rely on IC § 6-3-2-2(p), which provides that:

> Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity . . . be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

The Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases and with several analyses. The essential characteristic the Court requires for a unitary business is that the individual entities are functionally integrated in a common business. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 102 S.Ct. 3103 (1982). The Supreme Court found that unitary businesses that were functionally integrated shared many common characteristics. They had common ownership. They had centralized management with a corporate strategy including the various entities. The individual businesses were operated in such a manner as to further a common purpose.

According to documents and information supplied by the taxpayer, the taxpayer owned one hundred percent of Manufacturing Corporation, Purchasing Corporation, and Media LP. Activities connected to the taxpayer's business, such as legal, real estate, tax, treasurers/finance, internal audit, risk management & loss prevention, administrative services, and information services are handled by Manufacturing Corporation; advertising and publishing are handled by Media LP; and purchasing and sourcing are handled by Manufacturing Corporation and Purchasing Corporation, respectively. While taxpayer in its protest asserts that Manufacturing Company owns and manages its product-specific intellectual property, the Department's investigation indicates that Holding Company—of which taxpayer is its sole subsidiary—owned the various trademarks until a period just preceding the subject audit period; while Manufacturing Corporation has existed for decades, it has owned its product-specific trademarks for less than ten years, benefiting from a blanket assignment of such intellectual property rights from Holding Company, which filed the registration certificates and carried out subsequent maintenance filing procedures many years—in some instances, decades—before deciding to transfer those rights to taxpayer's wholly-owned subsidiary.

Management decisions were made to further the common goal of maintaining and expanding the taxpayer's global retail business. Based upon this analysis, the Department can establish that the taxpayer owned the referenced business organizations; that taxpayer controlled the operations of each of the Corporations; and used each and all of the Corporations in forwarding taxpayer's common goal of creating and expanding its worldwide retail business.

The taxpayer did not provide adequate documentation to support its decision not to file income tax returns in Indiana, nor did taxpayer provide adequate documentation to sustain its burden of proving that Manufacturing Corporation, Purchasing Corporation, and Media LP were not part of the unitary business and should, therefore, not be included in a combined return.

Based upon the limited information provided, the Department concludes that each of the subject business organizations depend upon the unitary relationship established and maintained by the taxpayer. Combined filing is required if members of a unitary group are deriving income from Indiana sources. In this case, taxpayer, Manufacturing Corporation, Purchasing Corporation, and Media LP, as members of a unitary group are deriving income from Indiana sources. The income realized by the wholly-owned subsidiaries greatly exceeds the expenses shown for the services performed. In addition, the subsequent dividends returned by the subsidiaries to the taxpayer—subsequently deducted by taxpayer on its Indiana corporate income tax return—complete a flow of monies between the taxpayer and its subsidiaries indicating the necessity for combined reporting. To both effectuate an equitable allocation and apportionment of the taxpayer's income and fairly reflect their Indiana adjusted gross income, the taxpayer, Manufacturing Corporation, Purchasing Corporation, and Media LP must be combined as a unitary business, as provided by the various subsections of IC § 6-3-2-2.

FINDING

The taxpayer's protest is respectfully denied.

LM/BK/DK –January 14, 2008